COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

NO. 245

[illegible] E. SMITH, as Special Administrator of the Estate of Edward S. Birin, Deceased,

Petitioner,

vs.

[illegible] SPERLING, JACK L. WARNER, UNITED STATES [illegible] INC., WARNER BROS. PICTURES, INC., and [illegible] PRESTON, MILTON SPERLING, REA L. WARNER and DORIS WARNER, Executors as Executors of the Estate of HARRY M. WARNER, Deceased,

Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

NO. .....

CHARLES B. SMITH, as Special Administrator of the Estate of Edward S. Birn, Deceased,

Petitioner,

vs.

MILTON SPERLING, JACK L. WARNER, UNITED STATES PICTURES, INC., WARNER BROS. PICTURES, INC., and HERBERT FRESTON, MILTON SPERLING, REA E. WARNER and DORIS WARNER VIDOR AS EXECUTORS OF THE ESTATE OF HARRY M. WARNER, DECEASED,

Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above entitled case on April 20, 1960.

Citations to Opinions Below.

The opinion of the United States Court of Appeals printed in Appendix hereto, *infra*, page 1, is still unreported.

Jurisdiction.

The judgment of the United States Court of Appeals was entered on April 20, 1960. The jurisdiction of this Court is invoked under 28 U. S. C., Sec. 1254(1).

Questions Presented.

In two causes of action of a derivative suit in a California federal court, petitioner, a shareholder of the publicly-owned Warner corporation claimed that the president and his two brothers *controlled* the company; that they caused the president's son-in-law and an ex-director to become unjustly enriched at the company's expense; that the company would not sue and that petitioner therefore asserted the right of the corporation to have restored to it over a million dollars.

The District Judge (in 1953) realigned the corporation (which had been named a defendant) as a party *plaintiff* and then declined to pass on the merits on the ground that he had no "diversity" jurisdiction of the 1st cause and no "equity" jurisdiction of the 2nd cause. Realignment and dismissal followed a *trial* on the jurisdictional issue and a *finding* made at the conclusion of that trial, to wit: the president and his brothers owned "less than 20%" of the company's stock; they *did not control* the company; that *consequently* the corporation was not alignable as a defendant although it was *admittedly* antagonistic and hostile to the suit. Realignment destroyed diversity. (*Smith v. Sperling*, 117 Fed. Supp. 781.)

The Court of Appeals for the Ninth Circuit affirmed the dismissal of the 1st cause and reversed as to the 2nd cause. (237 F. 2d 817.) This Court granted certiorari on the dismissal of the 1st cause; held the District Court had jurisdiction to hear and determine the merits of the controversy and reversed the dismissal of that cause. (353 U. S. 91-98.)

At a second trial (in 1958, following remand) petitioner (a) *established* that the brothers *did* control the company; (b) presented proof that during some 10 years that the suit was before the lower Courts and in this Court on the jurisdictional question, a series of contracts were made between the Warner corporation and United States

Pictures, Inc. (hereinafter United), a corporation owned by the president's son-in-law which were not only unfair to Warner but which were, moreover, *purposefully, maladministered* in a manner calculated to siphon off and bring about a give-away to the son-in-law of more than a million dollars of Warner money over and above what was rightly due him; and (c) that a Warner ex-director received a $78,000.00 gift in the form of "severance pay," from the corporation when he resigned and joined the son-in-law in the Warner-United venture.

The District Judge thereupon changed his former (1953) finding namely, that the brothers neither controlled nor dominated the company to one that declared they *controlled* and *ran it, i.e.*, they had "effective working control" and "working stock control" and they "actively" directed its "supervision, policies, action and business", *but* they did *not* "DOMINATE" and then *declined to "reach"* and pass on the merits of petitioner's claim that over a million of company money was unlawfully and unfairly diverted to the son-in-law and to the ex-director, on the ground that petitioner had "no standing to sue" thereon in the face of *antagonism* to the suit newly expressed by the Board of Directors *i.e.*, in a "resolution" to that effect passed at the close of the hearing, *10 years after the suit was instituted.*"

The Judge held in effect that to have "standing to sue" in face of this display of antagonism, petitioner had the burden of proving *additionally* that the brothers then and there "DOMINATED" the company, *i.e.*, at the time of the trial, *besides controlling* it. He thereupon dismissed the suit again, in a judgment which provides that the dismissal "shall not operate as an adjudication upon the merits" of the claims which he declined to "reach."

The decisional law of Delaware (the state of the Warner Company's incorporation) accords with the universally accepted corporate rule expressed by this Court in *Rogers*

v. *Hill*, 280 U. S. 582, 591-2, that a corporate majority have "no power to *give away* corporate property against the protest of the minority."

Neither statutory nor decisional law of Delaware nor that of California (the forum state) makes proof of director "domination" of a defendant-controlled company a condition to a shareholder's "standing to sue" derivatively.

California law governing the vindication of wrongs resulting from officers' alleged disloyalty to the company and the courts' duty in such cases to subject challenged dealings between the company and such officers to "rigorous scrutiny" with the "burden" on the accused officers "not only to prove the good faith of the (challenged) transaction but also to show its inherent fairness" to the corporation, has been declared by the Courts of California to correspond with federal law as expressed by this Court in *Pepper v. Litton*, 308 U. S. 295.[1] The decisional law of Delaware is to the same effect.

The Questions Presented Are:

1. Does antagonism manifested by the directors of a publicly and widely owned corporation—"*effective working control*" of which is *established* to be in the hands of the president and his two (vice president) brothers who run the company and who are accused in a derivative suit of siphoning off and *giving away* over a million of company money to a *relative* and to an ex-director—operate to

(a) destroy the shareholder's "*standing to sue*" derivatively, for the restoration of this money by the accused and the relative;

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[1] In *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 170, *et seq.*, the court quotes at length from *Pepper v. Litton*, *supra*, and concludes by declaring:

"This is the law of California. It was the law before Section 311 of the Civil Code was adopted, and is the law since."

A petition to review was denied by the Supreme Court.

(b) foreclose the court of *power* to grant appropriate relief; and

(c) justify the trial judge to *decline to reach* and to scrutinize the merits of specific challenged transactions that are claimed to be *breaches of trust* and acts *ultra vires*, and to dismiss such a suit leaving the merits thereof undetermined?

2. Does the stockholder so circumstanced have the burden imposed upon him—does his "standing to sue," derivatively, to vindicate such a claimed wrong to his company depend on his ability to prove, affirmatively, that the brothers so accused "DOMINATED" the company *besides controlling it* and *running it?*

3. Did not the District Judge have jurisdiction, *i.e.*, "Equity" jurisdiction to pass on the merits of the claims that he refused to "reach," notwithstanding antagonism by directors of this *defendant-controlled* company, and was not his refusal to exercise the court's jurisdiction the practical equivalent of a *denial of due process?*

Statement.

The foregoing questions were fully and fairly raised in the District Court and, in the Court of Appeals, although the Court's opinion (App. pp. 1-4) is utterly silent thereon.

This was, substantially, the petitioner's case below:

1. That Warner is a major producer and distributor of motion pictures. The company is publicly-owned. United is an "independent" production company. It is owned by a son-in-law (Sperling) and 2 infant grandchildren of Harry Warner who was Warner's president until shortly before his death in 1956. Warner made a contract with United (in 1945) for the production by United and the distribution by Warner of a series of motion pictures (similar to those produced by Warner) the production and distribution costs of which ran into many millions of dollars of

Warner money: From time to time *i.e.*, before as well as during the litigation, the contract had been amended and supplemented.

2. (a) That the terms of these Warner-United contracts were *unfair to Warner*, *i.e.*, so fashioned as to be *unwarrantedly favorable* to the president's son-in-law and unlike *any* production-distribution contract ever made by Warner with any *other* "independent" producer.

(b) That *in addition to being unfair* to Warner, the contracts with United were, moreover, *purposefully maladministered* during this litigation, to Warner's great detriment, *i.e.*, throughout and during the some ten years that it took to settle the District Court's *diversity* jurisdiction (in the two lower courts and in this Court), these agreements were repeatedly breached and violated in a manner *calculated* to bring about and they actually brought about a "give-away" —a virtual gift—to United and Sperling, viz., more than a million of Warner money over what was rightly and justly due or coming, was siphoned off to them. [Ex. 158.]

3. That Warner made a $78,000.00 gift to Joseph Bernhard, a Warner ex-director when he resigned to join Sperling in the Warner-United venture.

4. That the brothers—Harry, Jack and Albert Warner—*ran the company*: they "actively direct its supervision, policies, actions and business" [Admitted R. 112] and that United's contracts with Warner (that plaintiff claimed were maladministered so as to unjustly enrich the son-in-law) were processed minus any *directorial surveillance*. [Admitted R. 198, 213-214, 269, 282-283, 292, 309, 486.]

5. That the brothers *control* the company:

(a) Warner's stock is very widely distributed "among approximately 30,000 shareholders located in

various parts of the world" [Admitted R. 112, 602]; and is listed on the New York Stock Exchange. [Admitted R. 119.]

(b) There has been "no other individual or group among the stockholders or a unit that held any block of stock *comparable* to that held by the brothers during *any time* involved in this case." (Stipulation procured from defendants' counsel and recorded for the *first time* at the 1958 hearing [R. 749-751] following remand by this court in 353 U. S. 91.)

(c) The Warner family—the brothers, their wives, children, sisters and other close relatives—own shares equal to 25% of the outstanding stock. [Disclosed by Warner counsel in Ex. Z, in evidence, pursuant to petitioner's demand for such disclosure. See R. 792-794.]

(d) The brothers occupy a *commanding* position in the selection and make-up and over the behavior of directors; [acknowledged in directors' *depositions*. [R. 195-196, 490, 304-306, 291-292, 283-285.] See for example [R. 490, 304-306, 291-292], directors Friedman and Perkins, company lawyers (salary $80,000 a year, each) concede they would abdicate— "resign" if they were to become *persona non grata* to the Warners and see [R. 195-196], director Carlisle (comptroller), who owns that "Mr. (Harry) Warner and his two brothers in effect *control* . . . whether or not he, Carlisle, shall stay on as Controller or Assistant Treasurer of the company"; that "it is generally Mr. (Harry) Warner that is asked *if he wishes* to make any changes" in the Board; and that "he, (Harry) in effect, *controls* the naming of the Board of Directors. . . ."

Neither Harry Warner nor his brothers *ever faced the Court* in either the 1st or 2nd trials; and there is *no denial* of these statements in the record, by them or any one else.

(e) The brothers had "effective control of the corporation, its *Board of Directors* and *its active management.*" [A *finding* made by the New York Supreme Court in three *recently* (1958) consolidated stockholders' derivative actions (unrelated to this suit) that terminated in a final judgment [Ex. 15⁹] which, based on that finding among others, declared adequate a joint proposal by the defendants (the brothers Warner and the members of the Board) to pay the corporation $100,000. for releasing them from liability on a series of corporate claims predicated on wrongs allegedly committed against the corporation by the brothers *aided by and acting in concert with the directors.*]

Before the second (the 1958) trial closed, a quorum composed of these SAME DIRECTORS met specially in New York City at the suggestion of the District Judge; and they voted not to "lend its sanction" to the maintenance of *this* action. [R. 616, 818-820.]

This meeting—10 *years* after the suit was instituted—was convened upon the judge's veritable insistence (*over petitioner's repeated protests*)[2] that petitioner's case be

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[2] From petitioner's brief below:

"Appellant's counsel protested: The corporation is Warner-controlled. The Warners, whose relatives are being unlawfully enriched, are not shown to be company heads who had once been in a commanding position but who had since ceased to be a controlling influence in the company's business and its policies. To the contrary, the fact of the matter is, they always had, they never stopped having—they never gave up control of this company." [R. 776, 777, 791-793; Deft. Ex. Z.]

Appellant's protests [R. 758-828] were unavailing.

The judge appeared set on the procedure he prescribed and unreceptive moreover, to counsel's repeated observations that under the circumstances, *an opportunity should at least be given appellant to impeach an adverse verdict of this directorial jury.* [R. 773; 775; 778.]

presented forthwith to the Board for *its* verdict thereon. If favorable to petitioner, the judge declared, he would again *realign* Warner as a *plaintiff*. [R. 703.] He gave petitioner's counsel the choice of (travelling to New York and) pleading his case before them in person or doing so in writing. [R. 783.] Counsel took the latter alternative. He wrote them a letter.[3] He sent on additionally, a copy of a brief which he had theretofore submitted to the judge in seeking the *Court's* verdict on whether the son-in-law had not been, in reality, the beneficiary of an extraordinary, *ultra vires* million dollar bonus of Warner money. The package is in evidence as Plaintiff's Exhibit 158.

A "resolution" refusing directorial "sanction" to the maintenance of the suit—their "Business Judgment"—was handed down shortly thereafter and dispatched to the Judge. Along with it came a lawyers' "Report" which featured its authors' opinions and their advice on the law and the facts of petitioner's case, to the general effect that the directors (to whom the "Report" was addressed) would be justified to refuse "sanction" to the suit.[4] The report concludes by advising the directors that theirs is the "prerogative" to say whether the Warners or the son-in-law should or should not be sued.

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[3] The findings depict petitioner as having "elected" to present his case "in writing, to the Board of Directors of Warner Bros. for its action with reference thereto." [Find. XXVII, R. 614, 615].

[4] The following is a typical "advisory" statement:

> "It follows, therefore, that we are of the view that this Board would be justified by the law and the facts if it should, in the exercise of its business discretion, determine that it will not lend its sanction to the position advanced by plaintiff Smith with respect to the loss on Tisa." [Pp. 43-44.]

In the "Tisa" transaction plaintiff claimed that Orloff and Sperling became the beneficiaries of an *ultra vires* bonus and giveaway of over half a million ($535,310.12) of Warner money. This is one of the claims that remain undetermined under the [illegible] provisions of the last paragraph of the District Court's judgment. [R. 619.]

The gentlemen who authored this "Report" and who advocated this "Business Judgment" could not fail to have known that among the recipients of their advice WERE THE SAME persons who, but shortly before (in April of 1958), had been *found* by the New York Supreme Court to be under the *"effective control"* of the very men whose personal fortunes were affected by that "Business Judgment"; they knew that that "Report" was focused on none but the self-same individuals who had recently paid the company $100,000. for a release from liability for their participation with the brothers in conduct allegedly disloyal to the company. The "Report" was prepared and signed by one of the same firm of attorneys that had been retained by the same Warner management and who had appeared for the corporation (which had been joined as a party) in the suits in the New York Supreme Court.

Under the circumstances it is hardly harsh to observe that this "Report" functioned as but so much incidental music to an obviously predestined, cut-and-dried formality, viz.: the drafting of a smartly tailored "resolution" withholding "sanction."

The unfairness to petitioner's cause, implicit and implicit in these Board proceedings were complained of in the Court of Appeals:

> "We submit it was not fair to require appellant to plead with or to require him to set out to convince the Directorate of an *admittedly Warner-controlled company* of the justice of a case against the Warner family; particularly where management had manifested an unalterable, an adamantine resistance to the suit for more than a decade that witnessed argument in the highest court over problems that emerged from this resistance.
>
> "But assuming, without conceding, that it was fair to saddle appellant with that burden, it was nonetheless unfair not to afford him, betimes, the opportunity he sought (R. 773; 777-778) to lay bare the complex of directors' pressures that operated to precondition the result of this excursion from the Courtroom to the Boardroom; and then let the Boardroom judgment become virtually dispositive of appellant's case!
>
> "We submit, moreover, that it was increasingly not equitable with fairness to do all this in the face of facts exhibited in

Among the "Report's" dissembling, however needless, observations—clearly no warrant for *donating* a million to Sperling, *i.e.*, paying United that much more than was justly due by the terms of the Warner-United contracts—was one to the effect that *after all* the contract was lucrative for Warner, *i.e.*, the Warner Company did not lose—it made money in the Warner-United ventures; and another, that the authors consider it "*unlikely*" that "a court will find the (petitioner's) claim to be meritorious." (pp. 58-59.)

The document is *singularly muted on*—it contains not the faintest adversion to, such relevancies as control in the Warners or that corporate give-aways are forbidden.

The resolution and the "Report"—the latter admittedly grounded on hearsay[6] were received in evidence.

The District Judge thereupon declined to "reach" and to scrutinize the merits of the claim that this was virtually a huge gift to a presidential relative. He held, in effect, that that "Business Judgment," registering as it did the *corporation's* refusal to "sanction" the suit, deprived petitioner of *his* "standing to sue" thereon [R. 614, 820]; for, notwithstanding petitioner had *never established* "effective working control" of the corporation (past and present)

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the judgment roll in the New York stockholders' suit (Ex. 159) which, coupled with the fact that these directors turned back $100,000.00 to the treasury (or the Warners did, for all of them), pointed to say the least, if it did not bespeak, the existence of a *close*, if not dubious *relationship* between these Board members and the Warners" (citing *Heaton v. City Bank*, 312 U. S. 262, 265-266).

[6] From page 4 of the Report:

"At the same time we have recognized that we are not confined to the California Record, and we have freely taken into account matters of general knowledge in the motion picture industry, as well as *information given to us by Warner executives responsive to questions directed to them at the California Records*. We have also conducted our own research on such questions of law as appeared pertinent to our assignment."

[R. 825-826] in the brothers, he had nevertheless, still not shown the directors to have been "DOMINATED" [R. 826] when they handed down this "Business Judgment." [R. 824-826; 618.]

The foregoing proceedings *i.e.*, the meeting of the quorum, the "Report," the "Resolution" refusing "sanction" and the ensuing "Business Judgment" became the subjects of Finding XXVII [R. 614-617] and Conclusion V [R. 618-619]; and the predicate for a judgment which dismisses petitioner's suit and adjudges, in effect, that however meritorious his claim, petitioner had no "standing to sue" and was not to be heard thereon, viz.:

> "That this judgment of dismissal shall not operate as an adjudication upon the merits as to any claims arising from alleged non-performance or breach of any contract, or amendment or supplement thereto, between Warner Bros. Pictures Inc., and United States Pictures, Inc. nor as to any claim arising from the payment by Warner Bros. Pictures, Inc. of $78,000 as 'severance pay' to Joseph Bernhard." [Final par. of the judgment R. 619.]

The events that are narrated above; and the proceedings that led—after a long 10-year battle for the right to be heard—to but *sweeping under the rug*, so to speak, claims which, were they to have been "reached" and, *after appropriate scrutiny by the trial judge (Pepper v. Litton; Rogers v. Hill, supra)*, found to be well grounded, would have warranted no other conclusion than that the Warner corporation had been despoiled to the tune of more than a million dollars; these proceedings were defended by the respondents in the Court of Appeals as being in conformity with California law and what a California state court would have been obliged to do, on the authority of the following statement of the "Business Judgment Rule" in *Findley v. Garrett*, 109 Cal. App. 2d 100:

"The power to manage the affairs of a corporation is vested in the board of directors." (Citation.) Where a board of directors in refusing to commence an action to redress an alleged wrong against a corporation, acts in good faith *within the scope of its discretionary power* and reasonably believes its refusal to commence the action is good business judgment in the best interests of the corporation, a stockholder is not authorized to interfere with *such discretion* by commencing the action." (Emphasis ours.)

To this contention petitioner replied:

1. Petitioner directed the attention of the Court of Appeals to Section 183 of the Restatement, Conflict of Laws as follows:

"The right of a shareholder to object to conduct occurring in the operation of the corporate enterprise is determined by the law of the *state of incorporation.*" (See *Perlman v. Feldman*, 219 F. 2d 173, at 175, citing *Rogers v. Guaranty Trust, infra*, 288 U. S. 123, 130.)

2. The Delaware Courts, citing *Rogers v. Hill, supra*, have consistently adhered to the "accepted rule that majority stockholders have *no power* to give away corporate property against the protest of the minority."[7]

Frankel v. Donovan, 120 A. 2d 311, 316;

Gottlieb v. Heyden Chemical, Infra.

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[7] Judge Mayer in *Bassick v. Aetna Ins. Co.*, 24 Del. 974, put it in these words:

"It is to the ultimate interest of business and the protection and prosecution of large enterprises that the investing public must feel confident that a just appeal to the courts will not be unheeded, and that the courts will not permit their property to be disposed of *under circumstances which amount to a gift*, and those dealing with corporations cannot rely upon the proposition that a board of directors has the power, in law, to authorize a gift. Doubtless a natural person, in the absence of fraud or duress, *can give away* his property. *Not so with the directors of a corporation as to corporate property.*"

3. The quoted statement in *Findley, supra*, it should be noted, was made on a factual background essentially different from that in the instant case: Replying to shareholder Findley's demand, the Board advised him, in effect that in view of the breadth and depth of his accusations, it was justified in imposing as a condition to the *commencement* by the corporation of what promised *to become* a costly, bitter legal battle, that the stockholder *presently share with the Board* such evidence of alleged skullduggery as he possessed. This, Findley disdained to do. His response was to himself commence a derivative suit. In the instant case, the situation facing the board was just the opposite: it was to a 10 year old bitterly fought litigation that had just *come to a close* with all the evidence in, awaiting only the court's verdict thereon, to which the board proceeded to "resolve" not to "lend its sanction."

In distinguishing *Findley* from the case at bar, petitioner urged upon the Court of Appeals that *wherein* in that case,

> ". . . it was the *determined*, if not capricious, *refusal* by Findley to descend from generalities to particulars—*to specify* and *reasonably identify* the *particular transactions* which he charged were breaches of trust or deliberate frauds, *after repeated requests that he do so*, from a directorate *that avowed its readiness to vindicate such wrongs*—which largely motivated the decision *in that case*; witness the lengthy correspondence between the attorney for the suing stockholder and the directorate, ordered printed *in full* as an *appendix* to the court's published opinion. (109 Cal. App. 2d at pp. 180-183.)" (From p. 4 of Petitioner's Reply Brief.)

in the case *at bar*, petitioner

> ". . . isolated, *identified* and adduced detailed *proof* of over a million dollars in give-away overpayments

to a son-in-law of the most influential figure in a controlled corporation—'a misuse and waste of the money of the corporation' (Rogers v. Hill, supra) a series of breaches of trust emanating from maladministration of these Warner-United contracts; exhibited (*after* remand by this Court and the Supreme Court) a *controlled corporation*—not only controlled 'effectively' by the Warner family but 'run' by the brothers, who *never faced* the Court, with a directorate of 'biddable' men (Sanborn J. in Wheeler v. Abilene Natl. Bank Bldg. Co. 150 Fed. Supp. at 393-394, cited in appellants' opening brief, p. 26) beholden to the Warners (Greene v. Allen, 114 A. 2d 916, 920-922, similarly cited at p. 45), nearly all of whom the District Judge never saw; who *concededly* (R. 587), would never have brought this suit against the Warner family if appellant or any group of stockholders had demanded (in 1948) that they do so; a directorate composed of men who (appellees' briefs do not dispute it) paid the company a lot of money for a release from personal liability for wrongs against the company allegedly committed by them in concert with the Warners who were found, at the close of the hearing *after* remand by this Court *and the Supreme Court* (*and not before*) to have 'effective working control' of the company." (*id.* p. 5.)

4. Petitioner likened the situation in the instant case to the *factual* situation that obtained in *Bayer v. Beran*, 49 N. Y. S. 2d 2, in which the court said:

> "To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment there has grown up what is known as 'The Business Judgment Rule'. . . . (id. p. 6.)
>
> "*The 'Business Judgment Rule,' however yields to the rule of undivided loyalty.* This great rule of law

is designed 'to *avoid* the *possibility* of fraud and to *avoid the temptation* of self-interest' (citing cases). . . . 'Included within its scope is every situation in which a trustee chooses to deal with another in such close relation with the trustee that possible advantage to such other person might influence, *consciously* or *unconsciously*, the judgment of the trustee.' (citing cases). . . . *Such personal transactions* of *directors with their corporations*, such transactions as may *tend* to produce a conflict between self-interest and fiduciary obligations, are, when challenged, *examined with the most scrupulous care*, and if there is any evidence of improvidence or oppression, *any indication* of unfairness or *undue advantage*, the transactions will be voided." (*id.* at pp. 6-7.) . . .

Petitioner proceeded to point out that the rationale in *Bayer, supra*, underlies the reasoning of the California Supreme Court in *Wickersham v. Crittenden*, 93 Cal. 17, 28-29; in *Western States v. Lockwood*, 166 Cal. 185, 190, 191, 193; and in *Keimerson v. Burbank, supra*; and that the California courts' approach to judgment in these cases as that of the New York Court in *Bayer, supra*, parallels that viewed as fitting and proper by this Court in *Rogers v. Hill, supra*, and in *Pepper v. Litton, supra*.

Reasons for Granting the Writ.

I.

The courts below have declared on an important question of law—one of profound concern to some twelve million shareholders of publicly owned corporations—in a manner essentially contrary to and in conflict with this Court's decisions.

They ruled: (a) that petitioner, a minority shareholder—who, claiming spoliation and seeking to compel restitution of substantial sums of company money claimed to have been purposefully and unlawfully siphoned off and

given away to favored relatives of accused executives that control and run his company—*has no "standing to sue"* derivatively in a California federal court because the directors of this defendant-controlled company took occasion to notify the trial judge that they voted not to "lend their sanction" to his suit; (b) that, because petitioner did not furnish proof of actual "DOMINATION" of the directors by the accused executives, the trial judge, without stopping to inquire whether these were bonus payments and colorable, may decline to "reach" the merits; and (c) that, without scrutinizing the specific transactions complained of as being acts *ultra vires* as well as serious breaches of trust, the judge may dismiss the suit and in the judgment of dismissal proclaim that the merits of such "unreached" claims consequently remain undetermined.

In *United States v. Union Pacific Railroad*, 225 U. S. 61, 95-96, where Union owned 46% of Southern Pacific stock, this court observed that, while in small companies holdings of less than a majority of the stock do not afford the holders control, in large corporations where the stock is widely distributed, a "compact united ownership" of a substantial block but less than a majority is "ample to control the operations of the corporation" and that such stock ownership actually gives the holders "a dominating interest" in the company.

The case differs from the instant case (on this phase) only in the fact that in Union, Mr. Harriman (at p. 96) "frankly" *admitted to a reality* which the brothers Warner *did not come to court to deny*, namely that "domination" is but the silent partner of "control."

In *North American v. Securities Exchange Commission*, 327 U. S. 686, 693, the court said of "domination" in corporate life that, while domination is readily observable in and equatable with "arbitrary imposition of command," it would be ignoring reality not to recognize that

domination springs as readily from "subtle or unexercised power," and that

> "Historical ties and associations combined with strategic holdings of stock can on occasion serve as a potent substitute for the more obvious modes of control."

In *Koster v. Lumbermans*, 330 U. S. 518, 522, the Court held the shareholder's derivative suit to be an invention of equity to "redress breaches of fiduciary duty by corporation managers." It said that "Usually the wrongdoing officers also possess the *control* which *enables* them to suppress" corporate action to remedy the wrong; that "equity therefore *traditionally* entertains" the derivative suit in the right of the company when it refuses to do so.

It is this *ability* to suppress corporate action—this *capability* born of "strategic holdings of stock" that has *traditionally* moved equity to "entertain" the stockholders' plea and so thwart impending injustice to an otherwise helpless minority.

In *Rogers v. Hill*, 289 U. S. 582, a derivative suit, where the shareholders' challenge was directed to his company's paying president Hill a million more than was justly due him, the court ruled (pp. 591-592) that the *trial judge* was "required" to determine "whether and to what extent," large colorable bonus payments to the president "constitute misuse and waste of the money of the corporation"; and, that a corporate majority has *no power* to "give away corporate property against the protest of the minority."

In *Pepper v. Litton*, 308 U. S. 295, 306, the court ruled that dealings between the corporation and its official family *i.e.*, its officers, directors, etc., that are challenged as unlawful, disloyal or unfair to the corporation will be "subjected to rigorous scrutiny" by the court in which such dealings are complained of, in a process in which the of-

ficer or director involved is made to *shoulder the burden* of proving not only the "good faith of the transaction but also to show its *inherent fairness* from the viewpoint of the corporation and those interested therein."

In *Rogers v. Guarantee Trust*, 288 U. S. 123, 130, the Court held that the officer's or director's fiduciary obligation must in the first instance be measured by the law of the state of incorporation of the company, in the case at bar, the law of Delaware.

In *Bovay v. Byllesby*, 27 Del. Ch. 381, 383, 38 A. 2d 808, the Supreme Court of Delaware, in holding that the state's Statute of Limitations was not available to directors who were charged with breaches of trust, concluded an exhaustive opinion with the following statement which we urge is apposite:

> "Sound public policy requires the acts of corporate officers and directors *in dealing with the corporation* to be viewed with a reasonable strictness. Where suit is brought in equity to compel them to account for loss or damage resulting to the corporation through passive neglect of duty, without more, the argument that they ought not to be deprived of the benefit of the statute of limitations is not without weight; but where they are required to answer for wrongful acts of commission by which *they have enriched* themselves to the injury of the corporation, a court of conscience will not regard such acts as *mere torts*, but as *serious breaches of trust*, and will point the moral and make clear the principle that corporate officers and directors, while not in strictness trustees, will, in such case,

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In *Feldman v. Feldman*, 210 F. 2d 173, at 175, the Court, citing *Rogers v. Guarantee*, *supra*, says:

> "Both as director and as dominant stockholder, Feldman stood in a fiduciary relation to the corporation and to the minority stockholders as beneficiaries thereof (citing *Pepper v. Litton*). His fiduciary obligation was not to be measured by the law of Indiana, *the state of mere situs*,

be treated as though they were in fact trustees of an express and subsisting trust, and without the protection of the statute of limitations, especially where insolvency of the corporation is the result of their wrongdoing."

In *Gottlieb v. Heyden Chemical Corporation*, 33 Del. Ch. 82, 87, 90 A. 2d 660, a derivative suit in which the challenge was to a "Restricted Stock Option Plan" (approved by the Board *and ratified by a majority of the stockholders*) that awarded stock options to six of the Board members, the same Court took occasion to say:

> "Human nature being what it is, the law, in its wisdom, does not presume that directors will be competent judges of the fair treatment of their company where fairness must be at their own personal expense. In such a situation the burden is upon the directors to prove not only that the transaction was in good faith, but also that its intrinsic fairness will withstand the most searching and objective analysis." Fletcher, Cyclopedia of Corporation Laws, Vol. 3, Sec. 921. Loft, Inc. v. Guth, 23 Del. Ch. 384, 418 A. 2d. The stipulation here settled that the board believed that all things considered, the corporation would derive benefits from the plan, but the necessity for the directors to prove that the bargain had in fact been at least as favorable to the corporation as they would have required if the deal had been made *with strangers* was wholly *left out of account*.
>
> And directors may be mistaken as to the *law* of a transaction. When a board acts under a misconception of the law on a vital point, *judicial review is in order without there being any question of bad faith*. Honest directors conceivably might give away to their associates in the enterprise substantial amounts of a corporation's property in the belief that the gift would produce such gratitude that ultimately the corpo-

tion's generosity would be more than repaid. There would be nothing immoral or dishonest about such an action, *but it would not be legally sound.*"

"Certainly gifts to themselves (management) or *to their business associates* will not avail against the vote of any qualified objector. Since a gift may be in part only, a totally inadequate consideration, of course, invokes the same principle as the absence of any at all."

Rogers v. Hill, 289 U. S. 582, 53 S. Ct. 731, 77 L. Ed. 385.

II.

Clearly the questions presented are of importance since affected by them are the rights of some twelve million citizens who have invested in shares of publicly owned American companies substantial portions of their savings,[2] to obtain relief from corporation practices which are evil,[3] practices which water down and dilute the rightful share in their companies' profits or millions of proxy signing,[4] naive, uninformed and trusting shareholders.

In *Cohen v. Beneficial Loan Corp.* 337 U. S. 541, the court in upholding the constitutionality of a New Jersey statute designed to shield corporations against *groundless* claims of betrayal by corporate trustees, took occasion to note that with the expansion of corporate enterprise,

"management became vested with almost uncontrolled discretion in handling other people's money": money coming into their hands "from numerous and scattered" small shareholders; that management was not subject "to an effective accountability"; that shareholders "in the face of the gravest abuses were singularly impotent in obtaining redress of abuses of trust." The court went on to say (p. 548):

> "Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, *allowed him to step into the corporation's shoes* and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights, but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear *and adjudge* the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy, *born of stockholder helplessness*, was long the *chief regulator* of corporate management and has afforded no small incentive to avoid at least *grosser forms of betrayal* of stockholders' interests. It is argued, and not without reason, that *without it there would be little practical check on such abuses.*"

We urge that these words will be robbed of their true meaning if so interpreted as will render a shareholder's "standing to sue" derivatively men who have "effective working control" of his corporation and whom he accuses of unjustly enriching their relatives, dependent on whether he is able to demonstrate additionally something so essentially subjective as the "dominated" state of mind of directors of such a *controlled* company who vote against "lending their sanction" to his suit; particularly when among those so voting (as in this case) are directors who

are on record as admitting they would not be there to vote if they were to become *persona non grata* to the accused.

With deference to the Courts below, we urge that their holdings here are hardly in harmony with this Court's recent observations:

> "It has been the whole course of our law to break down the barriers against calling corporations to account in all states where they may do wrong in doing business."

Mr. Justice Reed in *Koster v. Lumbermen's Mutual*, 330 U. S. 518 at 538.

> "The whole trend of recent Congressional legislation has been to protect corporate stock and security holders. See, *e.g.*, Securities Act, 1933. But this legislation was not intended as a complete substitute for the antidote provided by stockholders' suits for the dangers inherent in the modern development of frequent conflicts of interest between corporate owners and corporate managers."

Mr. Justice Black in the same case at page 532.

Conclusion.

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

HERMAN H. HENRY; and
MOSS, LYON & DUNN,
Counsel for Petitioner.

APPENDIX

Opinion in the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Charles B. Smith, as Special Administrator of the Estate of Edward S. Birn, Deceased; Appellant, vs. Milton Sperling, *et al.*, Appellees; No. 16,387.

April 20, 1960.

Appeal from the United States District Court for the Southern District of California, Central Division.

Before: Chambers, Magruder and Jertberg, Circuit Judges.

PER CURIAM.

This case was up on appeal previously. Smith v. Sperling, 237 F. 2d 317 (C. A. 9th, 1956), rev'd 354 U. S. 91 (1957).

It started by the filing on December 15, 1948, of a typical minority stockholder's derivative suit brought by the plaintiff, a citizen of New York, against Warner Bros. Pictures, Inc., and United States Pictures, Inc., both Delaware corporations, and against certain named individuals, Harry M. Warner, Jack L. Warner, and Milton Sperling, all citizens of California. Sperling was the son-in-law of Harry M. Warner. Originally the complaint contained three causes of action, but the third suit was dismissed without prejudice several years ago, and we are now concerned only with the first and second causes of action.

The first, brought against all the defendants, charged that a certain contract for the production of motion pictures, and subsequent modifications thereof, had been made improperly by Warner Bros. Pictures, Inc., with United States Pictures, Inc., as a result of domination of the former corporation by the stock control of the Warner brothers, for the purpose of enriching United States Pic-

tures, Inc., and its president, Milton Sperling, at the expense of Warner Bros. Pictures, Inc. The relief sought was the cancellation of the contract. This relief has now become moot with the expiration of the contract, and what the minority stockholder is presently seeking is a financial reimbursement to Warner Bros. Pictures, Inc., for errors or misrepresentation of the contract during the time it was being administered.

After a lengthy hearing, the district court found as a fact that though the individual defendants, the Warner brothers, had sufficient stock ownership to control the election of the directors of Warner Bros. Pictures, Inc., such directors were not, as alleged in the complaint, "dominated" by them, but had approved the contract in good faith and in the exercise of their independent business judgment as being a sound business arrangement for the best present and future interest of Warner Bros. Pictures, Inc. Therefore the district court thought that, so far as the first cause of action was concerned, Warner Bros. Pictures, Inc., should be realigned as a party plaintiff, and as thus realigned there would be no diversity of citizenship. Hence the district court entered an order dismissing the first cause of action for lack of jurisdiction. Smith v. Sperling, 117 F. Supp. 781 (S. D. Cal. 1953).

The second cause of action was different in that United States Pictures, Inc., was not named as a defendant, and the complaint charged mismanagement of Warner Bros. Pictures, Inc., by the individual defendants as officers and directors of the corporation, all to the large pecuniary loss of the corporation. This cause of action the district court also dismissed, but on the merits for lack of equity.

On appeal this court thought the district court was right as to the first cause of action, but reversed its action as to the second and remanded the case to the district court for trial on the merits of the second cause of action.

237 F. 2d 317. Upon certiorari issued by the Supreme Court, that Court held, as to the first, that whether or not the directors of Warner Bros. Pictures, Inc., were "dominated" by Messrs. Warner, as to which the Supreme Court of course did not undertake to decide, nevertheless if the corporation through its board of directors refused to bring a suit, even though the directors were acting independently and in good faith, it was improper for the district court to realign the corporation as a party plaintiff and thus to defeat the federal jurisdiction. Accordingly, in reversing our determination, the Supreme Court remanded the case to the district court for trial of the first cause of action on the merits. 354 U. S. 91.

Because there was some overlapping of the jurisdictional issues as conceived by the district court and the issues on the merits, the earlier trial in the district court was very extensive. It was stipulated that all the evidence taken at the first trial should be considered on the merits.

The district court, pursuant to the remand, resumed its hearings and much further evidence was offered and received. Appellant offers no objection that any evidence on his behalf was improperly excluded. Finally, on December 17, 1958, a new set of findings was issued by the district court, and judgment was entered on the basis of these findings dismissing both the first and the second causes of action on the merits. The judgment now on appeal specifically contained a clause stating that:

> "'[T]his judgment of dismissal shall not operate as an adjudication upon the merits as to any claims arising from alleged non-performance or breach of any contract, or amendment or supplement thereto, between Warner Bros. Pictures, Inc., and United States Pictures, Inc.; nor as to any claim arising from the payment by Warner Bros. Pictures, Inc., of $78,000 as 'severance pay' to Joseph Bernhard."

On the findings of fact by the district court, which seem to us to be adequately suported by the evidence, we think that the district court's judgment of dismissal was inevitable and correct. There is no doubt that the production contract with United States Pictures, Inc., proved in operation to be very lucrative to Warner Bros. Pictures, Inc. Under the contract, Warner Bros. Pictures, Inc., received and handled all the gross receipts from the exploitation of the pictures and allocated the same in accordance with its terms. There was testimony by an employee of Price, Waterhouse & Company, independent auditors for both corporations, that the accounting practices of each were in accordance with the practices acceptable in the industry. Appellant does not claim that defendant, United States Pictures, Inc., diverted to improper uses any of the gross receipts. The trial judge found, as he had in substance found previously, as follows:

> "The Court finds that the said Board of Directors acted in good faith, without fraud, coercion or domination of any person or persons whatsoever; that in considering and passing upon said matters said Board and the members thereof intended to and did act in the interest of Warner Bros. and exercised its and their independent business judgment; and that its and their decision, as above set forth, was the exercise by it and them of such independent business judgment; that such matters were matters properly before said Board and properly the subject of the exercise by it of its said independent business judgment."

A judgment will be entered affirming the judgment of the District Court.

(Endorsed) Per Curiam Opinion Filed April 20, 1960.

FRANK H. SCHMID, *Clerk*.